

CFTC letter No. 04-36
July 26, 2004
No-Action
Division of Market Oversight

Ms. Stephanie Ford
Vice President, Legal/Compliance
HedgeStreet, Inc.
1825 South Grant Street, Ste. 500
San Mateo, CA 94402

RE: Request for No-Action Relief from CFTC Regulation §15.03(b)

Dear Ms. Ford:

This is in response to your letter dated July 8, 2004. In that letter you request no-action relief on behalf of HedgeStreet, Inc. ("HedgeStreet"), a newly designated contract market and derivatives clearing organization, from certain reporting levels stipulated in Part 15 of the Commission's Regulations.

We understand the facts to be as follows. HedgeStreet offers cash-settled binary option contracts ("HedgeStreet Contracts" or "Contracts") on a variety of underlying interests and articles, many of which have no cash market. HedgeStreet's contracts have small notional values in comparison with traditional futures and option contracts.

In the Commission's recent proposed rulemaking amending the Large Trader Reporting Rules ("Proposed Rules"),¹ the Commission set the large trader reporting level for HedgeStreet Contracts on economic indexes at 125,000 contracts. The reporting level applied to European-style binary options based on economic indexes² that paid a fixed \$10.00 if in the money upon expiration. In light of the relatively low value of these products, the Commission proposed a reporting level of 125,000 contracts, but limited the application of the reporting level to economic indices offered by HedgeStreet "in the manner and size described."³ To relieve HedgeStreet and its members from compliance with lower reporting levels during the pendency of a final rulemaking, the Commission embedded no-action relief for the referenced contracts within the Federal Register release for the Proposed Rules. Absent further Commission rulemaking or relief, any other product offered by HedgeStreet would be subject to the lower reporting levels of current Regulation 15.03(b), including the default reporting level of 25 contracts.

¹ 69 Fed. Reg. 26333 (May 12, 2004).

² The contracts could have been based on either macroeconomic or microeconomic indexes.

³ 69 Fed. Reg. 26333, 26334 (this limitation was based upon the Commission's understanding that HedgeStreet initially intended to list only such contracts).

HedgeStreet now requests that the Division of Market Oversight ("Division") grant no-action relief from Commission Regulation 15.03(b) for those contracts that do not have economic indexes as the underlying and increase the reporting level for all HedgeStreet Contracts to 125,000 contracts. HedgeStreet has listed contracts on gold, gasoline, federal funds rates, mortgage rates and currencies (collectively "Non-EI Contracts") which are not deemed economic indexes and therefore, do not fall under the 125,000 contract reporting level structured by the Commission in the Proposed Rules.

The Division notes that the large trader reporting system is an important Commission oversight tool. The rules governing this system require the reporting to the Commission of position information of the largest futures and option traders and require the traders themselves to provide certain identifying information. Reporting levels are set in the designated futures and option markets under the authority of Sections 4i and 4c(b) of the Commodity Exchange Act ("Act") to ensure that the Commission receives adequate information to carry out its market surveillance programs. These market surveillance programs are designed to detect and to prevent price manipulation and market congestion. The Commission, however, also is mindful of the burden associated with these reporting requirements and reviews them with an eye to easing that burden to the extent compatible with its responsibilities for rigorous surveillance of the commodity futures and option markets.

The Division agrees that the reporting levels otherwise applicable to HedgeStreet Non-EI Contracts, including the default reporting level of 25 contracts, are too low and therefore are unlikely to assist the Commission in conducting meaningful large trader surveillance. The reporting levels delineated in Regulation 15.03(b) generally are structured for contracts with higher notional values. For example, the NYMEX gold contract has a notional value of approximately \$30,000 per contract.⁴ Therefore, the notional value for a reporting level of 200 contracts would be \$6,000,000. In comparison, the notional value for a reporting level of 200 contracts for a HedgeStreet gold contract would be relatively negligible. HedgeStreet positions with such small notional values are unlikely to be used for market manipulation. Given the aforementioned, the Division believes that reports of 125,000 contracts for all HedgeStreet contracts with a maximum payout of \$10 would appropriately apprise the Commission of significant positions while relieving unnecessary burdens on HedgeStreet and its members.⁵

In light of the foregoing, the Division will not recommend any enforcement action to the Commission based on Sections 4a, 4c(b), 4i of the Act, or Commission Rule 15.03(b), if HedgeStreet complies with a 125,000 contract reporting level for any contract that has a maximum value of \$10. This no-action position is taken herein by the Division only and does not necessarily reflect the views of the Commission or any other division or member of the Commission's staff. Because this position is based upon facts and representations contained in

⁴ 100 troy ounces x \$300 per ounce = \$30,000 per contract.

⁵ Due to current limitations in the Commission's large trader record format (*see* 17 CFR 17.00(g)(1)), HedgeStreet positions are to be reported under 17 CFR Part 17 by rounding down to the nearest 1000 and then dividing by 1000. For example, a position of 177,955 contracts would be rounded down to 177,000, divided by 1000 and reported as 177.

the no-action letter, it should be noted that any different, omitted or changed facts or conditions might require a different conclusion. This position also is contingent on the continued compliance of HedgeStreet with all otherwise applicable obligations under the Act, and regulatory conditions imposed by the Commission. In addition, HedgeStreet must bring its conduct into compliance with reporting levels adopted in any final rulemaking to the extent that final reporting levels differ from those imposed herein or by the Proposed Rules.

If you have any questions regarding this correspondence, please contact David P. Van Wagner at (202) 418-5481 or Bruce Fekrat at (202) 418-5578.

Sincerely,

Richard A. Shilts
Acting Director